ADMINISTRATIVE PROCEEDING
FILE NO. 3-6461

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of
Registration Statement of PETROFAB INTERNATIONAL, INC.

INITIAL DECISION

Washington, D.C.
August 14, 1986

Max O. Regensteiner
Administrative Law Judge

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APPEARANCES: Jack H. Bookey, Nobuo Kawasaki, George N. Prince and N. Michael Hansen, of the Commission's Seattle Regional Office, for the Division of Enforcement.

Marc N. Geman, for Petrofab International, Inc.

Alan C. Jacobson and Timothy J. O'Connor, for Blinder, Robinson & Co., Inc.

BEFORE: Max O. Regensteiner, Administrative Law Judge

On January 13, 1984, Petrofab International, Inc. filed a registration statement on Form S-18 with respect to a proposed offering of 30 million shares of common stock at 10 cents per share. The registration statement has not become effective. These proceedings, instituted in January 1985 pursuant to Section 8(d) of the Securities Act of 1933, present the issues whether, as alleged by the Division of Enforcement, the registration statement included false or misleading statements of material facts and, if so, whether a stop order should be issued suspending its effectiveness. Concurrently with institution of the proceedings, the Commission denied Petrofab's request to withdraw the registration statement.

The alleged untruths and misrepresentations are specified in a Statement of Matters of the Division, which is incorporated by reference in the order instituting the proceedings. They pertain principally to the recognition of income from a research and development ("R&D") contract, in Petrofab's audited financial statements for the year ended February 28, 1983 and its unaudited statements for the ensuing six months.

Following extended hearings, proposed findings and conclusions and supporting briefs were filed by the Division and jointly by Petrofab and Blinder, Robinson & Co., Inc.

("Blinder"), the designated underwriter.[1/] The Division filed a reply brief. The findings and conclusions herein are based on the preponderance of the evidence as determined from the record and upon observation of the witnesses.[2/]

Petrofab

Petrofab was organized in 1980 by Hale Spiegelberg to design and manufacture equipment for use in oil field exploration and drilling, with particular emphasis on products useful in harsh weather conditions. Its principal office and manufacturing facilities were located in Seattle, Washington. Sometime prior to 1982, work began on a prototype of a personnel transfer and evacuation system (the "T&E system") for use on offshore oil drilling platforms. It is this item which was the subject of the

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1/ Blinder was granted leave to be heard and, through counsel, participated fully in every phase of the proceedings.

2/ Petrofab and Blinder argue that "preponderance of the evidence," the standard of proof which the Supreme Court held in the Steadman case (Steadman v. S.E.C., 450 U.S. 91 (1981)) governed administrative proceedings, is not the appropriate standard of proof in a stop order proceeding. As they concede, however, the same argument was made in Advanced Chemical Corporation, Securities Act Release No. 6507 (February 9, 1984), 29 SEC Docket 1185, and was there rejected by the Commission.

R&D contract referred to above.

Initially, Spiegelberg was Petrofab's sole stockholder. In a non-public offering in 1982, Petrofab sold 6.5 million shares of its stock at 5 cents per share to some 20 persons. Thereafter, Spiegelberg held about 74 percent of the outstanding stock.

In early 1982, Petrofab engaged Price Waterhouse ("PW") to audit its financial statements for the fiscal year ended February 28, 1982. The balance sheet as of that date showed total assets of $821,000 and retained earnings of $87,000. According to the income statement, total revenues for the year were $764,000 and the company sustained a net loss of $59,000. However, PW qualified its opinion, because among the assets was the prototype of the T&E system, which was carried at $92,000. In PW's opinion, this amount should have been charged to expense as a research and development cost rather than being capitalized. Had this been done, the net loss for the year would have increased by $92,000, and assets and retained earnings would have decreased by the same amount.

Petrofab again engaged PW for its 1983 fiscal year audit. However, in May 1983, before PW completed the audit, Petrofab replaced it with another accounting firm,

Niemi, Holland & Scott ("NHS"). This change related to the accounting treatment of a December 1982 contract between Petro Research, Inc. ("PRI"), a wholly-owned Petrofab subsidiary, and a limited partnership by the name of Ocean Shuttle Systems, Ltd. ("OSS"), under which PRI agreed to perform research and development with respect to the T&E system and OSS agreed to fund such research and development.

In the summer or fall of 1984, Petrofab ceased its operations.

The Registration Statement

The registration statement included balance sheets as of February 28, 1983 (audited) and August 31, 1983 (unaudited) and income statements for fiscal years 1982 and 1983 (both audited) and for the six months ended August 31, 1982 and August 31, 1983 (both unaudited). The fiscal year 1982 income statement was certified by PW, while the 1983 statements were certified by NHS.

Petrofab accounted for the R&D contract between PRI and OSS by the percentage-of-completion method. Under that method, in contrast to the completed-contract method, income is recognized as work on a contract progresses. In computing the amount of revenue to be recognized for the

year ended February 28, 1983 and for the six months ended August 31, 1983, Petrofab determined the ratio of costs incurred to date to estimated total costs under the contract and applied the resulting ratio to the sum of the cash received from OSS upon execution of the contract and payments to be made by OSS in 1985 and 1987, subject to a discount factor applied to the future payments. Petrofab's reported total revenue for fiscal year 1983 of $2.4 million included $902,000 attributable to the OSS contract. Total revenue of $727,000 for the six-month period ended August 31, 1983 included $394,000 attributable to that contract. In a section of the registration statement entitled "Disagreement with Accountants on Accounting and Financial Disclosure," PW expressed its view that under the circumstances use of percentage-of-completion accounting was not appropriate. According to PW, the arrangement between PRI and OSS should have been treated as a financing arrangement rather than as a contract to perform services. Under that approach, the proceeds of the agreement already received by PRI would have been reported as a liability, costs incurred would have been charged to expense and no income attributable to the contract would have been recognized. Instead of the reported net income for fiscal year 1983

of $190,000, Petrofab would have shown a net loss of $645,000. For the six-month period it would have shown a net loss of $420,000 instead of the reported net loss of $39,000. Petrofab's net worth would have decreased from $510,000 to a deficit of $325,000 (February 28) and from $482,000 to a deficit of $735,000 (August 31).

The Division contends that to the extent the Petrofab financial statements were based on the percentage-of-completion method, they did not conform to generally accepted accounting principles, and that those statements and textual references in the registration statement to figures derived from them were materially misleading. It further contends that the registration statement was also misleading in that NHS's audit opinion and its consent to use of that opinion (included as an exhibit in the registration statement) were subject to a material, undisclosed side agreement between NHS and Petrofab, which had the effect of withdrawing the consent. Petrofab and Blinder, on the other hand, insist that the financial statements were not misleading. They do not address the NHS consent issue.

The R&D Contract and Its History

Early in 1982, Petrofab retained Michael Ehrlich, a

Denver attorney, to be its counsel in connection with the non-public offering of its stock. Spiegelberg testified that Petrofab's regular attorney in Seattle did not practice in the securities field, and that he was referred to Ehrlich through a Petrofab customer. Ehrlich in turn introduced Spiegelberg to Arnold Tinter, a Denver certified public accountant. Tinter audited Blinder's financial statements for the year ended July 31, 1982 and has acted as tax and financial planning adviser to Blinder's president since 1981. Spiegelberg told Tinter about Petrofab and its need for additional capital. While Spiegelberg wanted to "go public," Tinter told him that this was not feasible. However, Tinter liked the T&E system concept. He told Spiegelberg he wanted to explore tax aspects with a New York law firm and contacted that firm, Friedman & Shaftan, in June 1982. The firm proposed the idea of a research and development agreement between Petrofab (or a subsidiary) and a tax shelter limited partnership, to provide funding for the project, and it prepared documents to implement its proposal. Tinter testified that Spiegelberg indicated that PRI would need a minimum of about $600,000 in cash to begin with, but that they never specifically discussed the total cost of accomplishing the research and development.

In November 1982, OSS was organized for the purpose of entering into an R&D agreement with PRI. A corporation wholly

owned by Tinter, named AT Associates, Inc., was its general partner. That same month, OSS filed a registration statement with the Commission covering a best efforts, all-or-none offering of 2,600 units of limited partnership interests at $1,750 per unit.[3/] The units were to be offered on the basis of $500 cash and payment for the balance by two promissory notes, one for $250 plus interest due on March 15, 1985 and the other for $1,000 plus interest due on March 15, 1987. As arranged by Tinter, Blinder was the designated underwriter. Upon completion of the offering, OSS was to enter into an R&D contract with PRI and into related agreements with Petrofab, under which, among other things, OSS would pay amounts received from investors (less sales commissions and the general partner's management fee) to PRI. It was contemplated that for tax purposes OSS would deduct in 1982 the entire amount, $3.9 million, for which it would be obligated to PRI, even though actual payment would extend over more than four years, and that the resultant tax loss would be passed through to the limited partners.[4/]

3/ Tinter testified that the ultimate decision as to how the offering should be priced rested with him, and that the price determination was based on the partnership's cash needs and the requirements necessary to make it a "tax-motivated" investment, i.e., that there be some leverage involved.

4/ The prospectus cautioned, however, that the Internal Revenue Service might disallow claimed deductions.

Early in December 1982, OSS requested withdrawal of the registration statement because of Regulation T problems. The request was granted, and the public offering was immediately converted into a non-public offering pursuant to claimed exemptions under Section 4(2) of the Securities Act and Regulation D thereunder. The principal difference between the aborted public offering and the non-public offering was that in the latter fewer units in larger denominations were offered. As restructured, the offering was for a minimum of 160 units and a maximum of 260 units at $17,500 per unit. The terms of payment were changed by the same factor of 10, i.e., $5,000 cash and notes for $2,500 due in 1985 and $10,000 due in 1987.

The offering memorandum specified that substantially all of the net proceeds after payment of the management fee would be applied to fund the research and development of the T&E system. The offering was terminated on December 28, 1982, when the minimum number of units had been sold. Thirty units were purchased by Blinder and another 50 units by officers and employees of that firm. Thus, Blinder and its affiliates accounted for 50 percent of the offering. Another 15 percent was purchased by Spiegelberg (3 units) and other Petrofab officials and stockholders. Blinder

received sales commissions of $48,000, representing ten percent of cash paid upon the sale of 96 units. 5/

On December 29, 1982, the R&D agreement between PRI and OSS and certain concurrent agreements between Petrofab and OSS were executed. Petrofab licensed OSS to use and exploit the Petrofab technology related to the T&E system. OSS contracted with PRI for the latter to use its best efforts to use that technology to perform the "research and experimentation" set forth in an Exhibit A to the R&D contract. 6/ In return, OSS was required to pay PRI a total of $2.4 million, including $615,000 on execution of the contract, $357,000 on April 15, 1985 and $1,428,000 on April 15, 1987. Among the R&D contract's terms was a provision under which PRI could request additional funding from OSS, and OSS could provide it at its discretion. By addendum to the contract, Spiegelberg agreed that if OSS did not

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5/ It appears that Blinder and its personnel had some role in the sale of 16 units in addition to those that they bought.

6/ The two other concurrent agreements are not significant for resolution of the issues herein. One was an option agreement giving Petrofab the option to re-acquire rights to the technology. The other was a license agreement providing for royalties to OSS upon sales by Petrofab of T&E systems or related products.

The quoted terms are terms of art under the Internal Revenue Code.

provide such additional funding upon request, he would lend PRI up to $2 million to complete the research and development.

As noted, the work to be performed by PRI under the R&D agreement was set forth in an Exhibit A appended to the agreement. This exhibit listed 15 phases of the research project. The first ten, beginning with the design and engineering of a passenger transfer and evacuation unit to transport personnel on a routine basis between offshore platforms and boats, hydrofoils or barges, conclude with completion of research and development of the unit. The last five phases called for research and development of additional refinements, designed for use in emergency situations. When PW, in the course of its 1983 audit, pointed out to Spiegelberg that PRI's plans only addressed phases 1 through 10, Spiegelberg responded that because only the minimum amount had been raised in the OSS offering, PRI was only required to perform those phases. Thereafter, in April 1983, Tinter submitted to PRI an amendment to the R&D contract stating that the original contract with its reference to 15 phases had been contingent upon sale of the maximum number of units, and that PRI was only obligated to perform the first ten phases because only the minimum amount had been raised.

Relationship Between Petrofab and Blinder

The nature of the relationship between Petrofab and

Blinder and the times when there were contacts between them have a bearing on the accounting issues presented. Spiegelberg testified that he first became aware of Blinder in connection with the proposed OSS public offering, and that his first contact with that firm was not until late December 1982 or early January 1983, when he met briefly with Meyer Blinder, its president. According to Spiegelberg, the meeting was arranged by Tinter because Mr. Blinder, as an investor in OSS, wanted to "meet the gentleman who was responsible for it" (Tr. 1295). Spiegelberg further testified that discussions with Blinder concerning the underwriting of Petrofab's public stock offering did not begin until late February or early March 1983. The Division, relying on other evidence as discussed below, asserts that already in 1982 there was an understanding between Petrofab and Blinder that the latter would underwrite a Petrofab stock offering.

Under date of March 21, 1983, Blinder directed a "Letter of Intent" to Petrofab, which was accepted by Spiegelberg for Petrofab on the same day. Reciting that "several discussions" had been held between Petrofab and Blinder representatives concerning a proposed 30-million share offering, the letter expressed Blinder's interest in principle in underwriting that offering based on the specified terms. Among those terms were that the offering would

be on a best efforts basis; that Marc Geman, who had acted as outside counsel to Blinder for a number of years, would act as Petrofab's special counsel in connection with the offering; and that Petrofab immediately pay $15,000 to Blinder as a down payment on the contemplated expense allowance. Such a payment was in fact made. And even before the date of the letter, Petrofab retained Geman as special securities counsel. The letter also referred to a representation by Petrofab that the financial statements to be included in the definitive prospectus would show a net worth of at least $500,000, consisting primarily of cash.

A revised letter of intent from Blinder dated August 8, 1983 was also signed by Spiegelberg for Petrofab. Under its terms, the proposed offering was changed to a firm commitment basis. Instead of a net worth condition, this letter stated that immediately prior to the effective date of the registration statement, the cash contribution of Petrofab's shareholders was to equal at least $500,000. The August letter of intent was in turn superseded by a December 5, 1983 letter of intent, which again referred to a $500,000 minimum net worth. 7/

7/ The underwriting agreement, which was to be signed immediately prior to the effectiveness of the registration statement, was never signed.

The Registration Statement-Continued

As previously noted, in its audited financial statements for the 1983 fiscal year and unaudited statements for the six months ended August 31, 1983, Petrofab accounted for the R&D contract on the percentage-of-completion method. Revenues attributable to that contract were computed as follows: First, total revenue from the contract was computed by adding the $615,000 cash received upon execution of the contract and on a discounted basis the amounts due in 1985 and 1987. As of February 28 and August 31, 1983, the project was estimated to be approximately 52 percent and 74 percent complete, respectively, representing the ratio of labor and engineering costs incurred to date to estimated total costs. Applying those percentages to the total revenue produced a figure of $902,000 for fiscal year 1983 and $394,000 for the ensuing six months.

As noted, PW did not consider percentage-of-completion accounting appropriate for the R&D contract and was replaced by NHS. However, since the instructions for Form S-18 require the inclusion of audited income statements for the two years preceding the date of the most recent audited balance sheet (here February 28, 1983), Petrofab had to include in its registration statement the income statement for fiscal year 1982 audited by PW and PW's consent to inclusion of its report on that statement. On advice of counsel, PW would not give such consent unless the "Disagreement Section"

was included in the registration statement. [8/] That section expressed PW's view that certain conditions requisite to use of percentage-of-completion accounting were not present. One of the conditions cited is a reasonable expectation that contract obligations will be paid. Here, according to PW, the OSS limited partners might have rescission rights on the basis of inadequate disclosure in the OSS private offering memorandum. The Disagreement Section recited in detail the asserted inadequacies of that memorandum. In addition, PW expressed the view that under the Financial Accounting Standards Board's Statement of Financial Accounting Standards ("SFAS") 68, "Research and Development Arrangements," the R&D agreement should have been treated as a financing arrangement and not as a contract to perform services. The principal factor leading to this conclusion was that in PW's view, there were significant related party relationships between OSS and PRI at the time the R&D agreement was entered into. Tables which followed the textual discussion showed the drastic impact on Petrofab's financial statements that would flow from PW's approach. Reference has already been made to the pertinent

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8/ In the 1982 income statement that was included in the registration statement, the cost of constructing the T&E system prototype, which Petrofab had originally capitalized, was charged to expense, with the result that PW no longer qualified its opinion.

figures. The Disagreement Section concluded with a "Company's Response," expressing Petrofab's disagreement with PW's conclusions.

The registration statement included NHS' unqualified consent to use in the prospectus of its report relating to Petrofab's fiscal year 1983 financial statements and to the reference to the firm as "experts." However, a letter from NHS to Petrofab dated January 11, 1984, two days before the registration statement was filed, set forth certain conditions to its consent. Spiegelberg, on behalf of Petrofab, signed the letter, thereby expressing agreement with its terms. The existence of this agreement was not disclosed when the registration statement was filed and came to the attention of the Commission's staff only during the investigation that led to these proceedings.

The agreement provided that NHS' consent was subject to Petrofab's agreement that it would not file any amendments to the registration statement (presumably to remove the delaying amendment included in the registration statement) or sell any shares pursuant to the prospectus unless and until it received an additional written consent from NHS. That consent would not be provided until, among other things, (1) Blinder and each of its principals who had invested in OSS had provided NHS with a letter expressing familiarity with PW's assertions (presumably those included in the Disagreement Section) and affirming

their independence with respect to the OSS limited partnership interest offering and with respect to Petrofab and PRI at the time of that offering and the time the R&D agreement was entered into, reaffirming their obligations to pay the notes due OSS and renouncing whatever rescission rights, if any, they might have; (2) AT Associates (the general partner of OSS) and its owner (Tinter) had provided NHS with a letter affirming their independence from Petrofab, PRI and Blinder at the time of the OSS offering, and confirming that none of the limited partners had indicated an unwillingness to pay notes due OSS or an intent to assert possible rescission rights; and (3) OSS had reconfirmed with certain of its limited partners their intention to pay the notes when due notwithstanding the PW assertions. Among specific representations required of Blinder and its principals were (a) that their only connection with the OSS offering was as purchasers of limited partnership interests and that they received no commissions except for interests purchased by them and (b) that preliminary discussions with Petrofab regarding a proposed public offering only began in March 1983 and that Blinder first expressed its intent to act as underwriter on August 8. The requisite representations were never made. Because (unknown to NHS) they were inconsistent with the facts, they could not truthfully have been made. NHS also never received any of the other statements or assurances.

Outline of Pertinent Accounting Principles

Before I turn to the parties' contentions on the

accounting issues presented, it may be helpful to introduce or elaborate further on some of the pertinent accounting principles.

First of all, there is an overriding concept in accounting that transactions should be recorded in accordance with their economic substance rather than their legal form.[9/] With reference to accounting for contracts, there are two generally accepted methods of accounting for long-term construction contracts.[10/] One is the percentage-of-completion method which recognizes income as work on a contract progresses. Recognition of revenues generally is related to costs incurred to date in relation to estimated total costs. The other method, known as the completed-contract method, recognizes income only when the contract is completed, or substantially so. Until that time, all costs and related revenues are reported as deferred items in the balance sheet. The percentage-of-completion method is preferable when estimates of costs to complete and extent of progress toward completion are reasonably dependable.[11/] This is so because it yields a better measure of periodic income results. On the other

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9/ See, e.g., Accounting Principles Board Statement No. 4, para. 14.

10/ Accounting Research Bulletin ("ARB") No. 45; AICPA Statement of Position ("SOP") 81-1.

11/ ARB No. 45, para. 15.

hand, the completed-contract method is preferable when "lack of dependable estimates" or "inherent hazards" cause forecasts to be doubtful. Inherent hazards include contracts "whose validity is seriously in question" (i.e., that are "less than fully enforceable") and contracts "with unrealistic or ill-defined terms." 12/

While R&D contracts involving funding by other parties are at least in form a species of contracts, SFAS 68, dealing with research and development "arrangements," expresses the position that what in form appears to be an R&D contract may be in economic substance a financing transaction, to be accounted for on that basis. SFAS 68 provides that this is the case if the enterprise is obligated to repay funds provided by the other parties regardless of the outcome of the research and development. 13/ (In the instant context, obligation to repay must be read as encompassing non-insistence on payment of amounts due in the future.) SFAS 68 states that to conclude that a

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12/ SOP 81-1, para. 29.

13/ SFAS 68 was stated to be effective for R&D arrangements entered into after December 31, 1982, "with earlier application encouraged" in financial statements not previously issued. Here, the R&D arrangement was entered into on December 29, 1982. All accountant-witnesses who testified on the point agreed that the SFAS 68 standards were applicable even though the arrangement preceded by two days the pronouncement's effective date.

liability does not exist, the transfer of the financial risk from the enterprise to the other parties must be substantive and genuine. There is no transfer of risk where the enterprise is committed to repay regardless of the outcome of the research and development. Even when there is no contractual obligation to repay, surrounding conditions may indicate that the enterprise is likely to repay funds provided by the other parties if the project is not successful. In that case, there is a presumption that the enterprise has an obligation to repay which can be overcome only by substantial evidence to the contrary. SFAS 68 lists examples of conditions leading to a presumption that the enterprise will repay the other parties (or, as in this case, not insist on their payment of amounts due in the future), including the following: (1) the enterprise would suffer a severe economic penalty if it failed to repay any of the funds provided regardless of the outcome of the research and development; (2) a significant "related party" relationship between the enterprise and the funding parties exists at the time the enterprise enters into the arrangement.[14/] In connection with the latter condition, the Standards Board pointed out that the combined attractiveness of "off-balance-sheet" financing for the

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14/ A third such condition listed in SFAS 68 is that the enterprise has essentially completed the project before entering into the arrangement. PW took the position, both in discussions with Petrofab and ultimately in the Disagreement Section, that this condition, though not literally applicable, was pertinent at least in conjunction with the existence of related party relationships to invoke SFAS 68. The Division does not, however, rely on this aspect of SFAS 68.

enterprise (i.e., not having to expense research and development costs as it would with internally financed R&D activities) and tax incentives for related party investors may cause the substance of such an arrangement to differ from its form (SFAS 68, para. 32).

Where the arrangement involves a liability to repay, it cannot be accounted for as a contract, and no revenue can be recognized. Hence, neither the percentage-of-completion nor the completed-contract method is applicable. Rather, any funds provided must be carried as a liability and costs must be charged to expense as incurred.

Discussion Regarding Accounting for R&D Contract

As noted, the Division urges that Petrofab's use of percentage-of-completion accounting was improper and that there is therefore no need to determine which of the other possible accounting methods, the completed-contract method or the financing method, was the proper one. Under either of those methods, Petrofab could not have reported any revenue from the R&D contract and would have shown a loss instead of a profit for the 1983 fiscal year and a far bigger loss than reported for the ensuing six-month period.[15/] The

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15/ George Diacont, an Assistant Chief Accountant of the Commission and the Division's expert witness, testified that while he considered financing treatment preferable, he would not object to the use of the completed-contract method to account for the R&D contract. He reasoned that while the two methods differ conceptually, under either approach there would have been no recognition of revenue with respect to the non-cash portion of the consideration and investors would not be misled.

grounds relied on by the Division for its conclusion on percentage-of-completion accounting, while overlapping to some extent with those cited by PW in the Disagreement Section or considered by PW during its 1983 audit, reflected essentially the testimony of its expert witness, George Diacont, an Assistant Chief Accountant of the Commission. According to the Division, percentage-of-completion accounting was improper because, among other things, it was at least uncertain whether the amounts due PRI from OSS in 1985 and 1987 would ever be paid or collected; the R&D contract was so vague and indefinite as to be unenforceable; Blinder was a related party of Petrofab at relevant times; and Petrofab had insufficient evidence of costs incurred to date on the T&E system project.

Petrofab and Blinder maintain that the Division failed to prove that use of the percentage-of-completion method was inappropriate. They further contend that it is unnecessary for me to determine which method of accounting for the R&D contract was the correct one, since "the inclusion of both methods" (i.e., percentage-of-completion and financing) (Brief, p. 18, n.6) in the registration statement precluded it from being materially false or misleading.

In the discussion that follows, I deal first with the question whether Petrofab appropriately used the percentage-of-completion method to account for the PRI-OSS agreement. I conclude that that question must be answered in the negative. Consequently, I then address the Petrofab and Blinder argument that because of the disclosure contained in the Disagreement Section, the registration statement was not misleading.

The first basis for Diacont's conclusion that percentage-of-completion accounting for the R&D contract was improper was that the "totality of facts" surrounding the transaction indicated that it was not likely that Petrofab would insist on collection of the amounts due in 1985 and 1987 if the T&E project proved not to be successful. (Tr. 1966) Hence, he concluded, percentage-of-completion accounting could not properly be applied to the non-cash portion of the consideration payable by OSS. I find myself unable to follow his reasoning (or that of the Division's brief relying on his testimony) as to a number of these facts. For example, he cited Petrofab's motive to show profitable results in its financial statements so that its stock offering would be successful; the fact that, absent the R&D arrangement, Petrofab would have shown a loss for fiscal year 1983, as it had in 1982; the extraordinary profit margin of the R&D contract; the high failure rate of R&D projects; and the fact that tax shelters such as OSS were "notorious" for establishing liabilities under circumstances where there was no intention to satisfy those liabilities. The combination of these factors could well lead one to suspect the bona fides of the whole arrangement.[16/] However, Diacont, while not discounting the

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16/ Although this was not reflected in the Disagreement Section, it appears that the PW partner in charge of the 1983 audit was of the view that the PRI-OSS arrangement lacked substance and was fraudulent.

possibility that the arrangement was a sham, testified that his accounting conclusion was not predicated on such a determination. And the Division has not taken such a position. Its reliance, in addition to the factors cited by Diacont, on the fact that the amounts that were payable to PRI in 1985 were not paid when due seems misplaced, since Petrofab and PRI were no longer in business by that time.

One additional factor cited by Diacont in support of his conclusion that it was not likely that Petrofab would insist on collection of the receivables if the project were not successful pertains to the involvement of "related parties." I find that by February 28, 1983 if not earlier there were in fact significant related party relationships that not only support Diacont's conclusion, but invoke the provisions of SFAS 68. As previously noted, one example listed in that pronouncement of conditions leading to a presumption that "the enterprise" (here PRI) will repay (here including not seeking payment of receivables) the other parties (here OSS) is that a significant related party relationship between the enterprise and the parties funding the research and development exists "at the time the enterprise enters into the arrangement." For the definition of "related parties," SFAS 68 refers to SFAS 57,

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17/ Diacont testified that if the transaction had been accounted for using either the financing method (SFAS 68) or the completed-contract method, the question whether the receivables had any validity could have been deferred.

"Related Party Disclosures." That definition includes affiliates (i.e., those having a control relationship with the enterprise), principal owners and management of the enterprise and any party that can "significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests."

Diacont testified that Blinder, which with its affiliated persons owned half of the OSS limited partnerships, was a significant related party of Petrofab as of the time (whenever it was) that there was an understanding that Blinder would underwrite Petrofab's stock offering. He was of the view that even though SFAS 68 refers to the existence of a related party relationship at the time the arrangement is entered into, here, where the financial statement date was only two months after the date of the R&D contract, the existence of such a relationship on the later date was sufficient to invoke SFAS 68.[18/] NHS and the expert witness called by Petrofab and Blinder took the view that SFAS

18/ Diacont also testified that the 15 percent interest in OSS held by Spiegelberg and other Petrofab officers, employees and stockholders represented a significant "related party interest," citing a 10 percent criterion that the Commission's accounting staff uses in evaluating R&D arrangements to determine whether there is sufficient related party interest to require the use of financing treatment. However, it appears that Spiegelberg (and perhaps other of the Petrofab-affiliated persons) had a greater incentive to further Petrofab's interests and to that end collect the amounts due from OSS than to avoid payment on his notes qua OSS investor.

68 must be read literally on this point. On the other hand, the PW partners involved in the audit, like Diacont, took the position that such a literal reading was not warranted.

SFAS 57 does not specifically include an underwriter or prospective underwriter in the definition of "related parties." Yet not only Diacont, but the two PW partners, concluded in the exercise of their professional judgment that Blinder was a related party of Petrofab. It seems that Blinder fits comfortably into the last part of the "related parties" definition as quoted above. As the prospective underwriter of Petrofab's initial public offering, it was in a position to exercise significant influence over Petrofab. This arose out of Petrofab's need for Blinder's services to effect a successful public offering and thereafter to make a market in Petrofab stock. While the public offering was expected to be completed well before the 1985 obligation of the limited partners and OSS became due, Blinder's influence over Petrofab was likely to continue.

The Division's position is that all events necessary to make Blinder and Petrofab related parties had occurred by December 29, 1982 when the R&D agreement and the related agreements were signed or at the latest by February 28, 1983, the financial statement date. Petrofab and Blinder, on the other hand, seem to argue that there was no understanding between them until a later point. 19/

19/ Their arguments on this point are contained in their proposed findings only and were not briefed. The Division points out that under 17 CFR 201.16(d), any proposed findings not briefed may be regarded as waived. I have determined not to rely on that provision, however.

While the evidence is in conflict on this question, it preponderates in favor of the Division's position. One item of direct evidence which is in itself highly persuasive is included in a December 8, 1982 memorandum by Linda Heller, a PW partner, of a conversation of that date with Spiegelberg concerning a possible audit for the period ended December 31, 1982. According to the memorandum, whose accuracy is conceded, Spiegelberg told Heller about a planned public offering in or about February 1983 through Blinder as underwriter. 20/ Jeffrey Ferries, who succeeded Heller in January 1983 as the PW partner responsible for the Petrofab account, testified that Spiegelberg called him in early February 1983 to tell him that Petrofab would file an S-18 registration statement and that Blinder would be the underwriter. He further testified that he had not seen Heller's memorandum or previously heard of Blinder. In addition to this direct evidence of an understanding between Blinder and Petrofab prior to December 29, 1982 or at the latest by early February 1983, it does not seem likely that the Blinder interests would have made the sizeable

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20/ In the memorandum (Div. Ex. 57), Heller recorded the prospective underwriter as "Wyda Robinson (?)." There can be no serious question that Spiegelberg's reference was to Blinder, a firm of which Heller had not heard before. Anthony Neupert, who was PW's audit manager for the Petrofab audits both in 1982 and 1983, testified that already in the spring of 1982 Spiegelberg told him that Blinder would help Petrofab with its financing. Although Neupert was a credible witness, I do not credit his testimony on this point.

investment in OSS that they did, $1.4 million, without having at least an understanding with Petrofab, the other party to the R&D arrangement, that Blinder, a firm heavily involved in underwriting, would be involved in its public financing. This conclusion is buttressed by the central role of Tinter in the complex of arrangements. Tinter was responsible for obtaining Blinder as underwriter for the aborted OSS public offering, a role which in turn led to its deep involvement in the non-public offering of OSS limited partnership interests. In view of Tinter's strong ties to the Blinder organization as well as by that point (the end of 1982) to Petrofab, the inference is compelling that by the time the R&D arrangement was entered into there was agreement in principle that Blinder would underwrite the Petrofab offering. As of January 1983, Tinter became a consultant to Petrofab with respect to the offering. His testimony that he knew nothing about Blinder being a possible underwriter for the Petrofab offering until Spiegelberg told him about it in about March of 1983 is simply not credible. 21/

Under the circumstances, I also cannot credit Spiegelberg's testimony, previously cited, that his discussions with a Blinder representative concerning the

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21/ That testimony and Tinter's further testimony that Spiegelberg never asked him for an introduction to Blinder is inconsistent with Spiegelberg's testimony that he asked Tinter to suggest an individual at Blinder to whom he could talk and that Tinter suggested such an individual.

underwriting did not begin until late February or early March 1983. Petrofab and Blinder, pointing to other of Spiegelberg's testimony, assert that up to the time of Blinder's March 21 letter of intent, Spiegelberg was still casting about for an underwriter. Spiegelberg did testify about contacts with various broker-dealers beginning in the summer of 1982 and continuing into early March 1983, with a view to finding an underwriter for Petrofab. In support of his testimony he presented lists, notations and business cards of broker-dealer names and personnel and letters to two broker-dealers. However, the lists, notations and business cards were undated and the letters bore September and October 1982 dates, respectively. Spiegelberg admittedly knew prior to the filing of the OSS registration statement in November 1982 that Blinder was to underwrite the OSS offering and must have known that Blinder and its affiliates ultimately bought half of the offering. Again, I simply cannot accept that, as Petrofab and Blinder would have me believe, it was only as a last resort that Spiegelberg turned to Blinder.

The Division further contends that the R&D agreement was so vague and indefinite as to be unenforceable and hence provided no basis for the recognition of revenue. Specifically, it argues that the nature of PRI's required performance was

described only in the most general terms, with the consequence that PRI could not prove performance of its part of the bargain and therefore could not insist on performance (i.e., the deferred payments) by OSS. Petrofab and Blinder respond that Colorado law, which by the terms of the R&D agreement governed its construction, favors construction of a contract in such a way as to make it enforceable. They further state that under Colorado law extraneous evidence regarding the parties' intent may be considered where a contract is ambiguous on its face. Relying on these contract law principles, they argue that the Division could have examined the parties to the contract, or the OSS limited partners, about the meaning of the contract or could have presented expert testimony on the question of its enforceability. Since the Division failed to do so, they contend, it cannot properly argue contract vagueness based on mere conjecture. And they point to the testimony of their expert witness, a certified public accountant, lawyer and law and accounting professor, that the contract is "very explicit."[22/] (Tr. 2270)

22/ Petrofab and Blinder also contend that the issue of enforceability of the contract is not encompassed in the Division's Statement of Matters and is therefore not an issue in these proceedings. They further argue that the Division, as neither a party to nor beneficiary of the contract, lacks standing to raise the issue of enforceability, and that I lack the power to determine the legal rights and obligations of the parties to the contract. These arguments have no merit. The contract's enforceability is pertinent not as an issue in and of itself, but as one of the factors bearing on the appropriateness of percentage-of-completion accounting. That issue is the principal issue raised in the Statement of Matters and is one to which the Division could obviously address itself and which I am required to rule upon.

Reference has been made to SOP 81-1, which cites as an example of an "inherent hazard" that makes percentage-of-completion accounting inappropriate contracts "whose validity is seriously in question (that is, which are less than fully enforceable)." 23/

As noted, the tasks to be performed by PRI were set forth in Exhibit A to the December 29, 1982 R&D agreement. The exhibit listed 15 phases. It was not until April 1983, when PW called attention to the matter, that the contract was amended to provide that PRI need perform only the first ten phases. This in itself suggests that the performance to be required of PRI was of little interest to the contracting parties and that the primary concern on the OSS side was the tax deductions to be obtained by the partners.

The first ten phases of the research project were described as follows:

> PHASE I: Design and engineer a passenger transfer and evacuation unit which would be used as a routine method for safely transporting personnel between offshore platforms and boats, hydrofoils or barges. The unit will also be developed to deliver personnel from decks above water level to water level safely and if a need arose to evacuate the platform.
>
> PHASE II: Research and develop scale models of proposed designs to determine final unit design prior to construction of full sized unit.

23/ Paragraph 29. That paragraph also states that reasonably dependable estimates cannot be produced for a contract with unrealistic or ill-defined terms.

PHASE III: Platform engineers will advise on any potential components compatibility based on current platform construction and design. All research and analization of components to be used in construction of the T&E System shall be done at this point to insure proper mechanical function and design. Mechanical and structural integrity of individually engineered components shall be determined through research methods to properly analyze these components.

PHASE IV: Build first T&E System and install on research platform on land.

PHASE V: Research unit for proper design, proper function, cycle time, durability under harsh conditions, impact design, and structural design. Also develop proper maintenance guidelines. All engineered components will be researched to determine maximum capabilities and limitations.

PHASE VI: Dissassemble T&E unit and transfer offshore for research and development.

PHASE VII: Develop T&E unit on offshore research platform and research to develop proper installation techniques to retrofit existing platforms.

PHASE VIII: Research T&E unit on platform for the following:

1. Workability under different weather conditions.
2. Use during simulated emergency conditions on platform.
3. Research use with boats.
4. All components will be researched for field use.
5. Maintenance schedule will be utilized to research if adequate for field use.
6. Proper docking techniques to boat will be researched and developed.

PHASE IX: All research results will be compiled and determination shall be made to any research and development necessary to T&E unit.

PHASE X: If any additional research and development are necessary to T&E unit, further funds will go toward that additional research and development.

Spiegelberg, who drafted the above provisions, testified that he deemed them an adequate description of the work that PRI was to perform and that no other specifications or drawings were prepared to accompany them. Tinter testified that he had seen some preliminary sketches of what was sought to be accomplished, but had not received any blueprints or drawings prior to execution of the contract.

As the Division points out, the contract described the work to be done only in the most general terms. It included no specifications or performance standards as to what PRI was to design and develop. By way of example, the contract did not specify even such basic elements as the number of persons that the T&E unit would be able to transport; the water and wind conditions under which the unit would be able to function; and the conditions existing on the offshore platform under which the unit would function.

The PW partner in charge of Petrofab's 1983 audit testified that he and his associates raised questions with management as a result of the vagueness of the descriptions of the project's phases. In concluding that percentage-of-completion accounting was not appropriate, they relied in part on the fact that the tasks to be undertaken by PRI were not clearly defined, and that consequently there was no way to substantiate the estimated costs to be incurred.

In my judgment, recognizing that an R&D contract by its nature may have to be less specific than other types of contracts, the contract here is so indefinite as to just what PRI is required to do that its enforceability is seriously in question. The point is not, as Petrofab and Blinder contend, that there are ambiguities in the contract which could have been resolved by examining the contracting parties (or their principals) or the OSS limited partners concerning their intent. Since there had been no negotiation or even discussion of the performance requirements, there was no such thing as a mutual intent regarding the necessary specifics. Finally, while the expert witness for Petrofab and Blinder characterized the contract as "very explicit," his testimony did not focus on the research phases specified in Exhibit A. To the extent it may have encompassed those phases, I cannot agree with it.

An additional reason why percentage-of-completion accounting was not proper is that there is substantial doubt about the reliability of the percentage-of-completion calculation used by Petrofab. This matter was the subject of detailed testimony by Diacont (Tr. 1985-2007) which I find persuasive. Petrofab and Blinder have not addressed themselves to the issue.

As previously indicated, the amount of revenue from the R&D contract reported in the 1983 financial statements reflected a percentage-of-completion calculation based on the

ratio of labor and engineering costs incurred to date to the estimated total such costs. Petrofab determined that the project was 51.8 percent complete as of February 28, 1983, reflecting the ratio of $144,628 costs to date and $279,236 total costs. Diacont pointed out that both sides of the ratio included an amount of $81,000 representing management salary costs incurred to date. The largest component of this figure was an amount of $32,000, representing about 64 percent of Spiegelberg's salary for fiscal year 1983. In Diacont's judgment, there was insufficient competent evidence to support the allocation of these costs to the percentage-of-completion calculation. NHS' audit workpapers show that the audit evidence in support of the $81,000 figure consisted largely of management representations. Diacont testified that these constitute the lowest form of audit evidence, and that it is inappropriate for an auditor to rely extensively on management representations when dealing with a material transaction. 24/ He pointed out that according to the workpapers about 70 percent of the amount allocated to management salaries attributable to the T&E project was supported only by such representations, and that if this amount were eliminated from the calculation, the percentage-of-completion figure would be reduced to 39.5 percent and revenue from $902,000 to $688,000.

24/ PW's workpapers include a notation that the $81,000 figure represents Petrofab's estimate of time spent on the T&E system and that only "minimal documentation" exists.

Effect of Disagreement Section

As noted, in the Disagreement Section of the registration statement PW expressed its view that percentage-of-completion accounting was not appropriate. Petrofab and Blinder take the position that the registration statement, by including the different conclusions reached by the two accounting firms in the exercise of their professional judgment and in good faith, made full disclosure to potential investors. Hence, they contend, the registration statement cannot be found to be misleading. In support of their position, they cite U.S. Molybdenum Corp., 10 S.E.C. 796 (1941). There, a registration statement represented that there were no known adverse claims against the registrant's mining claims, when in fact an adverse claim had been asserted. The registrant argued that there was no need to disclose this because the claimant was estopped from asserting the claim because of an allegation made in a lawsuit. The Commission held (at pp. 805-6) that while the registrant was entitled to its view of the legal effect of the allegation and of the validity of its claim, the fact remained that there was a material dispute as to the validity of the claim and that registrant was under an obligation to state at least the underlying facts giving rise to the adverse claim. In language that Petrofab and Blinder rely upon, the Commission continued:

> The Securities Act entitles investors to know the facts and to form their own opinions on the basis of a full and complete disclosure of all material facts. We hold that registrant's failure to state the facts underlying its assertion that, so far as known, there were no adverse claims renders that assertion materially misleading. . . (p. 806)

The attempted analogy between the Commission's pronouncements in Molybdenum and this case is flawed, however, because in the accounting area, disclosure, no matter how extensive,[25/] cannot cure the misleading effect of financial statements not conforming to generally accepted accounting principles. On the basis of the record in this proceeding, the percentage-of-completion method was not an appropriate method of accounting for the R&D arrangement. As the Commission announced in a policy statement issued early in its history and still in force, where financial statements

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25/ In fact, the disclosure contained in the "Company's Response" that is part of the Disagreement Section was misleading in at least two respects, which paralleled inaccurate disclosures made by Petrofab to NHS. The Response stated that not until "approximately March 1983" did Petrofab begin "exploratory discussions" with several potential underwriters. In fact, as noted, Petrofab had already received and accepted Blinder's letter of intent in that month. NHS was told that the August letter of intent was the first one. The Response further stated that Blinder had not participated as underwriter or broker-dealer in the OSS offering. Petrofab failed to disclose, as it had failed to disclose to NHS, that Blinder had been designated underwriter of the aborted OSS public offering and had received commissions for sales effected in the non-public offering.

filed with the Commission are prepared in accordance with accounting principles for which there is no substantial authoritative support, they are presumed to be misleading regardless of footnote or other disclosure.[26/] Here, the issue does not concern so much the determination of the applicable accounting principles as the applicability of those principles to a particular set of facts. And, in an unusual twist, the pertinent disclosures were made by predecessor accountants who did not certify the financial statements that were the subject of the disagreement. There is no reason, however, why the Commission's policy should not be applicable under these circumstances.[27/]

It follows from the above discussion that Petrofab's financial statements for the 1983 fiscal year and the six months ended August 31, 1983 were materially misleading.

26/ See Codification of Financial Reporting Policies, Section 101, CCH Fed. Sec. L. Rep. §72,921, incorporating Accounting Series Releases 4 (1938) and 150 (1973).

27/ In his treatise, Professor Loss points out that in 1934 the Commission indicated that the dictates of full disclosure were satisfied by financial statements which were incorrect on their face if the accountant's certificate, together with appropriate footnotes, pointed out where the inaccuracies existed and what would be the effect of applying another method of accounting. This policy was superseded in 1938, however, by the present policy. I Loss, Securities Regulation (1961), pp. 334-5.

Undisclosed Agreement Regarding Accountants' Consent

I have previously described the undisclosed side agreement between NHS and Petrofab regarding the former's consent to use of its report and of its name in the registration statement. Such consent, in unqualified form, was required by the Securities Act and regulations issued thereunder. The side agreement, which was the product, at least in part, of NHS' concern about OSS limited partners being alerted by the Disagreement Section to the existence of posible rescission rights, withdrew or at least materially modified NHS' consent and thus rendered the registration statement materially misleading.

Conclusion and Order

The Division contends that the public interest requires issuance of a stop order. Petrofab and Blinder, on the other hand, stressing the fact that no offers or sales were made under the registration statement and the assertedly full disclosure of the different conclusions reached by accountants exercising professional judgment, claim that no possible public interest would be served by a stop order and that Petrofab should be permitted to withdraw the registration statement.

As found above, the registration statement was materially misleading in its financial information, which is indispensable to an informed evaluation of securities to be

offered, as well as with respect to the certifying accountants' consent. Petrofab has a number of stockholders. In those circumstances, the Commission normally deems issuance of a stop order, and denial of withdrawal, the necessary course of action, in that it is the most effective means of publicizing the fact that misleading material has been filed. 28/

Accordingly, IT IS ORDERED that the effectiveness of the registration statement filed by Petrofab International, Inc. is hereby suspended. 29/

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Commission's Rules of Practice. Pursuant to that rule, this initial decision shall become the final decision of the Commission as to each party that has not filed a petition for review pursuant to Rule 17(b) within fifteen days after service of the

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28/ See Advanced Chemical Corporation, Securities Act Release No. 6507 (February 9, 1984), 29 SEC Docket 1185; Croyle Computer Services, Inc., 46 S.E.C. 632 (1976).

29/ All proposed findings and conclusions and all contentions have been considered. They are accepted to the extent they are consistent with this decision.

The Division's request that I take official notice of an amendment to a registration statement filed by Source Venture Capital, Inc. on November 27, 1985, as documenting an additional affiliation between Tinter and Blinder, is hereby granted. Also granted is its request that I receive revised Division Exhibit 116 in evidence.

initial decision upon it, unless the Commission, pursuant to Rule 17(c), determines on its own initiative to review this initial decision as to it. 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.

Max O. Regensteiner
Administrative Law Judge

Washington, D.C.
August 14, 1986