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# A Historical Episode of Professional Skepticism

## *The SEC's Thomascolor Case against Haskins & Sells*

*By Dale L. Flesher and Gary J. Previts*

"To perform their role properly—to assure that reported financial and economic successes are not illusory—auditors must approach their jobs with independence and skepticism."

—PCAOB Chairman James R. Doty

The decade following World War II was not all rosy for the CPA firm Haskins & Sells (H&S), known today as Deloitte. In particular, the firm faced an SEC allegation regarding its professional judgment with respect to a 1947 audit—that is, a question of its skepticism. Examining this issue through a historical lens can provide CPAs with additional insight and understanding.

### Background

In May 1948, the SEC charged H&S and long-time partner Andrew Stewart with lack of professionalism on an audit for a client named Thomascolor Incorporated, a company promoting a lens that would allow color movies to be made with standard black-and-white film. The company's patented process had the potential to transform Hollywood's production routines, but the organization was strapped for cash, and because Technicolor was already an entrenched process, competition was fierce.

Although H&S had certified the company's 1947 financial statements, the SEC subsequently charged that H&S had approved a false and misleading registration statement. The alleged distortion involved the gross overvaluation of the patents and patent applications that were Thomascolor's main assets. The assets were carried at the cost Thomascolor had incurred for them, but the seller had been Richard Thomas, the promoter of Thomascolor; thus, this was not an arm's-length transaction. H&S claimed to have followed generally accepted accounting and auditing practices, but the SEC concluded that the lack of true arm's-length bargaining in important transactions was so obvious that the auditors should have recognized the impropriety of using the purchase price for valuation purposes.

The case arose when Thomascolor used the financial statements to register new securities with the SEC. Though the SEC initially approved the registration, it later objected to the filing and halted the process. Even though only 200 shares of stock were sold (at $10 each), the SEC initiated a proceeding against H&S and Stewart, the partner in charge of reviewing the financial statements. The SEC brought the proceedings under Rule II(e) of the Rules of Practice:

> The Commission may disqualify, and deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after hearing in the matter 1) not to possess the requisite qualifications to represent others; or 2) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct.

The firm and Stewart stood accused of either lacking the requisite qualifications, lacking in character or integrity, or having engaged in unethical or improper professional conduct. This was a most unlikely

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charge to levy against Stewart, who had 43 years of experience in the accounting profession, including prominent posts in the American Institute of Accountants and the NYSSCPA. In World War II, he served as a colonel in the army, where he had the important post of deputy director of the War Department's fiscal division; this critical financial work made him a war hero in the eyes of many.

The Thomascolor case ultimately produced more than 2,800 pages of testimony. The technical accounting questions were complex, including interpretations of the objectives of financial statements. One of the key allegations was that the amount ascribed to patents and patent applications was merely a balancing figure, substantially in excess of the total of the amounts in the books of the selling company, and had no relation to actual values; the valuations were based on the purported value of the common stock given in exchange for the patents, and that stock was not publicly traded.

Why SEC Chief Accountant Earle King chose to pursue the Thomascolor case may forever remain a mystery, though it may have simply been an attempt to raise the issue of professional skepticism.

### Analysis of the Case

Three distinguished accountants from other firms—Edward B. Wilcox of Edward Gore & Co., Samuel J. Broad of Peat, Marwick, Mitchell & Co., and J. S. Seidman of Seidman and Seidman—all supported H&S's position with respect to the financial statements. The SEC offered no experts with contrary opinions. Following the testimony of the experts, former Secretary of War Robert P. Patterson made the following summary of the case from H&S's viewpoint:

> We submit that their testimony is proof of the highest significance, bearing upon whether the conduct of Haskins & Sells and of Andrew Stewart in the case under discussion was unethical or improper professional conduct. We submit that at the very most the case is one of mistaken judgment, if the Commission should be of the view that everything we have said on these other points is not sound. ["Argument Presented on Behalf of Respondents to the Members of the Commission by the Hon. Robert P. Patterson (Formerly Secretary of War) on May 8, 1950," *Proceedings before the SEC concerning H&S and Stewart*].

The significant part of Patterson's statement is "unethical or improper professional conduct." This rule was clearly intended "to deal with cases of willful disregard of duty, of conscious failure on the part of accountants, or of undebatable culpability. The SEC has applied the rule in cases where the accountant had an unrevealed interest in the very securities covered in the registration statement, thereby lacking the independence that ought to be present; where an accountant has certified and said he has examined the books, despite no pretense of examining the books, a clear case of moral dereliction; or where the accountant has certified to the securities on hand when he has not even gone through the motions of counting them, also a clear case of false representation" (Patterson 1950, p. 43). Indeed, none of these former uses of the rule applied to Andrew Stewart or to H&S in the Thomascolor case. Secretary Patterson continued with his testimony:

> We called attention—we noted it in our brief—to an article by Mr. Werntz, a former Chief Accountant, in discussing the cases, where he says … "Each of the cases involved a willful disregard both of Commission rules and proper standards of professional conduct." How far removed that is from the case we have here!
>
> When all is said and done, when the tumult and the shouting has died down, the good reputation of Haskins & Sells and of Andrew Stewart, their character, their integrity, have not been impugned by anything in this record. They have had a long and well-deserved reputation in their field for adherence to the fine standards of the profession. They did not abandon those standards in the Thomascolor case. They performed their duty in a conscientious, scrupulous manner. Right or wrong, they did their best and there is no moral taint on them. And we are confident that the Commission will find that the proceedings should be dismissed, that there is no cause in this case, in fairness, justice and equity, for the application of disciplinary measures or of disbarment or disqual-

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ification to any extent and for any period (Patterson 1950, pp. 43–44).

Though the rule seemed not even to apply in this case, the SEC ignored the expert testimony and suspended H&S from practicing before the SEC for 10 days. It concluded in SEC Accounting Series Release (ASR) 73, published on October 30, 1952, that "while the opinions of qualified expert accountants may be helpful, this Commission must in the last analysis weigh the value of expert testimony against its own judgment of what is sound accounting practice." This quotation, with a citation to ASR 73, is still used by the SEC in enforcement actions (see Accounting and Auditing Enforcement Release 3427, Dec. 13, 2012, http://1.usa.gov/220rtEb).

## A Question of Skepticism

H&S and Stewart were held accountable for professional misconduct, even though the decisive issues in the case were matters of judgment supported by the independent experts. ASR 73 also stated that good faith is no defense when the accountants' conduct is so deficient that it shows "their failure to give professional undertaking the degree of care and inquiry it demanded under the circumstances." In present-day terms, it would appear that the SEC determined the auditors were not sufficiently skeptical. Thus, the SEC's judgment did not coincide with that of the firm, which meant that the firm had, by definition, erred (Arthur B. Foye, *Haskins & Sells: Our First 75 Years*, Haskins & Sells, 1970, p. 98).

Why SEC Chief Accountant Earle King chose to pursue the Thomascolor case may forever remain a mystery, though it may have simply been an attempt to raise the issue of professional skepticism and assert the SEC's authority. Most previous cases investigated by the SEC had been instances of audit failures; in the Thomascolor case, the question was one of valuation and financial statement presentation ("Accountants' Liabilities for False and Misleading Financial Statements," *Columbia Law Review*, 1967, pp. 1437–1469). If the SEC wanted to address the growing problem of questionable presentation of financial statements, what could be a better illustration than a case involving a prominent partner of a major firm? After all, an SEC challenge of the leaders of the profession might serve as a lesson to all practitioners.

> This direct challenge by King to the authoritative self-regulatory role of the AICPA served as a reminder to the profession of where the legal authority rested in such matters—namely, with the SEC.

Another possibility is that King simply wanted to reassert the authority of the SEC in all aspects of reporting. The timing of the Thomascolor case came shortly after the December 1947 issuance by the Committee on Accounting Procedure of Accounting Research Bulletin (ARB) 32, an authoritative pronouncement that the "current operating performance concept" should be used in the preparation of income statements. King took exception to that pronouncement and issued a notice saying that "the Commission has authorized the staff to take exception to financial statements which appear to be misleading, even though they reflect the application of Accounting Research Bulletin No. 32." In other words, the SEC made known its preference for the alternative method of income statement presentation, the "all-inclusive concept." This direct challenge by King to the authoritative self-regulatory role of the AICPA served as a reminder to the profession of where the legal authority rested in such matters—namely, with the SEC. At the time of the case, William H. Bell, a contemporary of Stewart, represented the firm on the Committee on Accounting Procedure (CAP); thus, an admonishment of the firm and Stewart might have represented a symbolic sanction of Bell and the CAP as well.

It appears that the SEC and King used the Thomascolor case as an emblematic action, choosing a prestigious CPA and his illustrious firm to make an example of. The apparent objective was to use this admonition as a reminder of the SEC's determining role in financial reporting and to communicate, then as now, the importance of skepticism in professional auditors' judgment. ❑

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